NEW YORK LAW SCHOOL

NYLS Journal of International and Comparative Law

Volume 9
Number 2 *VOLUME 9, NUMBERS 2 & 3, 1988*

Article 5

1988

TAXATION ISSUES FACING THE FOREIGN ATHLETE OR ENTERTAINER

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I. INTRODUCTION

International athletes or entertainers who perform in the United States often generate substantial income. That income is subject to taxation according to federal law and United States treaties. The amount of tax owed will depend upon such factors as the status of the alien, the nature and source of the income, and the provisions of various tax treaties. This Article will discuss some of the significant rules pertaining to the taxation of foreign entertainers and athletes, as well as some tax planning opportunities available to minimize tax liability.

II. DOMESTIC INCOME TAXATION GENERALLY

United States citizens must pay taxes on all worldwide income unless that burden is reduced by a tax treaty.[1] Resident aliens also must pay taxes on their worldwide income.[2] The definition of residency under immigration law differs from its definition under tax law.[3] Until 1984, the definition of residency for tax purposes was an illusive test which considered individual facts and circumstances in ascertaining the intent of an alien's stay in the United States.[4]

Current law under the Tax Reform Act of 1984[5] defines an alien as

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1. I.R.C. § 894(a) (West 1982).

2. Treas. Reg. § 1.1-1(b) (as amended in 1974).

3. *See generally* Fraade, Gardner & Stewart, *The IRS, the INS, and the Foreign Entertainer*, 5 COMM./ENT. L.J. 200 (1983). While resident aliens will be treated as residents for tax purposes, nonresident aliens may be treated as residents for tax purposes as well. *See* Langer, *When does a Nonresident Alien Become a Resident for United States Tax Purposes?*, 44 J. TAX'N 220 (1976).

4. Factors considered included whether the alien owned a home, office or car in the United States; whether the alien possessed United States charge cards, bank accounts, driver's license, or memberships in American clubs; and whether family and substantial personal possessions accompanied the alien. The ultimate intent to return to the native domicile was not afforded great weight in determining residency for tax purposes. Treas. Reg. § 1.871-2(b) (1960).

5. Pub. L. No. 98-369, 98 Stat. 494 (1984). For a comprehensive discussion of the law

a resident for tax purposes if the alien is a lawful permanent resident under the immigration laws at any time during the tax year,[6] or satisfies the substantial presence test.[7] Under the substantial presence test, an alien is considered a resident if: 1) the alien is present in the country for 183 days or more; or 2) the sum of the days the alien is physically present in the United States during the calendar year, plus one-third the number of days the alien is physically present in the United States during the first preceding calendar year, plus one-sixth the number of days the alien is physically present in the United States during the second preceding year, equals or exceeds 183 days.[8] Excluded from this test are aliens: 1) present in the United States for thirty days or less during the calendar year; or 2) present in the United States for less than 183 days during the calendar year *and* who can establish closer connections with a foreign tax home.[9] The definition of "closer connection to a foreign tax home" remains vague and will be difficult to apply to athletes who commute between countries. Arguably, the same set of circumstances previously used to define residency will be used to define "closer connection."

The tax consequences for athletes or entertainers defined as residents for tax purposes generally are unavoidable.[10] Like United States citizens, resident aliens are subject to the United States graduated income tax schedule on all worldwide income.[11] Of course, these individ-

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see Khokhar, *New Definition of a Resident Alien*, 13 TAX MGMT. INT'L J. 283 (1984); Lipton & Fuller, *Taxation of Compensation Paid to Aliens Requires Careful Analysis*, 64 TAXES: THE TAX MAG. 444 (1986).

6. A lawful permanent resident under immigration law is commonly referred to as a "green card" holder.

7. I.R.C. § 7701(b)(1)(A) (West 1987).

8. *Id.* § 7701(b)(3)(A). Generally, a person is treated as being present on any day that he is physically present for any length of time in the country. Exceptions include times in which regular commuters from Canada or Mexico are present; times that transients from points outside the United States are present if their sojourn is less than twenty-four hours; and days spent in the United States because the alien is unable to complete an intended departure for medical reasons. *Id.* § 7701(b)(3)(D). Categories of exempt visa holders exist but normally do not embrace foreign athletes or entertainers. 22 C.F.R. § 41.25(b) (1987).

9. *Id.* § 7701(b)(3)(B). The latter exception to the substantial presence test will not apply if the alien has applied or begun to apply for lawful permanent residency. *Id.* § 7701(b)(3)(C)(ii).

10. Such individuals, if not lawful permanent residents, may avoid classification as a resident by limiting the number of days spent in the United States. *See supra* notes 8-9 and accompanying text. That possibility, however, is slight for the athlete whose season usually exceeds the numerical day limitation. For a discussion of the pros and cons of resident alien status as well as other tax consequences with respect to corporate and property investment, see Khokhar, *supra* note 5, at 377.

11. Treas. Reg. § 1.1-1(b) (as amended in 1974).

uals also are entitled to the same deductions, exemptions and tax credits available to United States citizens.[12] Nonresident athletes or entertainers, on the other hand, possess a greater ability to reduce their United States tax liability.[13]

III. NONRESIDENT TAXABLE INCOME[14]

Generally, a nonresident alien is taxed only on income generated from United States sources, not on foreign source income.[15] A primary determination to be made, then, is what constitutes United States source income. Such income includes nonexempt bonuses and immediate as well as deferred compensation for services performed in the United States.[16] Additionally, interest income from United States bonds or notes along with dividend income received from United States corporations constitute United States source income, with some exceptions, as do profits generated from the sale of personal property in the United States and the sale of real property located in the United States.[17] Rents or royalties received from property located in the United States, including intangible rights such as patents, copyrights, trademarks, franchises and goodwill, also are taxable as United States source income.[18]

While income attributed to services performed outside the United States is nontaxable foreign source income, income from United States

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12. Treas. Reg. § 1.1-1(b) (as amended in 1974).

13. An alien may hold a dual status as both a nonresident and resident alien during a single tax year, usually the year of arrival and/or departure. For an explanation of the tax treatment of such individuals, see I.R.S. PUB. NO. 519, UNITED STATES TAX GUIDE FOR ALIENS (1987).

14. For an excellent, comprehensive analysis of tax planning for alien performers, see Weiss, *Tax Planning Issues Affecting International Entertainers and Athletes*, 9 FORDHAM INT'L L.J. 97 (1985-86); *see also* Histrop, *Taxation of Canadian Resident Athletes and Artists Performing in the United States*, 32 CAN. TAX J. 1060 (1984).

15. I.R.C. § 871 (West 1988).

16. I.R.C. § 861(a)(3) (West 1987). The income of some nonresident athletes or entertainers who perform personal services may be exempt from United States taxation under a short time, low income exception. The income from personal services performed in the United States will be exempt if: 1) the services are performed as an employee or under a contract with a nonresident alien individual, foreign partnership or corporation not engaged in a trade or business in the United States; 2) the services are performed while the nonresident alien is temporarily present in the United States for a period not to exceed a total of ninety days during the tax year; and 3) the compensation for the services does not exceed $3,000. All three conditions must be met in order to quality for the exemption. *Id.* § 861(a)(4).

17. *See generally* Zagaris, *Investment by Non-Resident Aliens in United States Real Estate*, 31 U. MIAMI L. REV. 565 (1977).

18. I.R.C. § 861(a)(4) (West 1987); *see also infra* notes 38-40 and accompanying text.

performances by nonresident athletes or entertainers is considered United States source income.[19] Thus, purses received by nonresident boxers or golfers for participation in fights or tournaments staged in the United States are subject to taxation.[20] The source of some remuneration, however, is sometimes less clear.

If a nonresident alien is employed to perform services both in the United States and outside the country, then the compensation paid under that contract must be allocated between United States source and foreign source income. If the agreement specifies the amount to be paid for services performed in the United States, then that amount will be considered taxable income.[21] In the absence of any specific allocation, however, the taxable income will be determined on the basis of what most correctly reflects the proper source of income under the facts and circumstances of the particular case, including such factors as the duration of the performance and the number of days the services are performed in domestic and foreign locations.[22] Therefore, a nonresident entertainer may reduce United States tax liability by scheduling some performances, for which a fixed fee is paid, outside of the United States, preferably in a tax haven, so that a percentage of the compensation received will be attributed to foreign source income and more favorably taxed.[23] In most instances, if the contract expressly compensates the performer for publicity tours or rehearsals, then those contractual obligations could be fulfilled outside the United States to further minimize the United States tax burden.

Nonresident team athletes who perform in the United States fewer days than the number for which they are paid under the standard player's contract must allocate their compensation between foreign and United States source income as well. Generally, the amount of a player's income subject to United States taxation will be equal to the amount of compensation paid under the contract multiplied by the ratio which the number of days that services were performed in the United States during the contract period bears to the total number of

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19. *See supra* note 3; *see also* I.R.C. § 871 (West 1988).

20. Rev. Rul. 70-543, 1970-2 C.B. 172.

21. Treas. Reg. § 1.861-4(b) (as amended in 1975).

22. *Id.* When compensation is not allocated separately, the regulations direct that income should be allocated to United States sources on a time basis so that the amount to be included in income will be that which bears the same relation to the total compensation as the number of days of performance of services within the United States bears to the total number of days of the performance for which the payment is made. *Id.*

23. Nevertheless, in some circumstances, the performer should consider whether a possible reduction in the compensation paid, if some performances are to occur outside of the United States, will be offset by the tax savings.

days included in that period.[24] Thus, a key element of the allocation formula is the period of time covered under the contract. In *Stemkowski v. Commissioner*[25] the court held that a nonresident hockey player's contract term included the play-off season and training camp in addition to the regular season.[26] Thus, nonresident team athletes who attend training camp or play in exhibition, regular season or play-off games outside the United States can reduce the amount of the total salary paid under their contract that is allocated to United States source income. The court in *Stemkowski* did not include the off-season in the contract period even though the player was required to report to training camp in good condition.[27] The court considered off-season conditioning to be a condition of employment rather than a contractual obligation.[28] Arguably, nonresident athletes who engage in off-season conditioning outside the United States could include such time to extend the term covered by the contract, and consequently reduce United States source income. This could be accomplished only if a supervised training program was required by the contract, particularly if the club's obligation to pay remained absolute even in the event the player was unable to fulfill other requirements under the contract.

In addition to receiving compensation for performing contractual duties, at times, one party may receive payment in consideration of a promise to forbear from performing. Under a negative covenant, a nonresident athlete or entertainer relinquishes the right to perform for any other entity except the one with whom the agreement is reached. Such covenants pose additional questions concerning the allocation of income for nonresident performers. Generally, income received pursuant to a negative covenant is allocated according to the country in which the rights are relinquished.[29] Consequently, the amount paid to the

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24. Days spent in the United States between contests are defined as days in which services are rendered. Days during which a player is suspended are not considered as such. Rev. Rul. 87-38, 1987-20 I.R.B. 7.

25. 690 F.2d 40 (2d Cir. 1982); *accord* Hanna v. Comm'r, 763 F.2d 171 (4th Cir. 1985), *reviewed by* Harwood, *Recent CA-2 Decision Focuses on Computing United States Source Income for Nonresident Alien*, 58 J. TAX'N 266 (1983).

26. The court premised its holding on the fact that the contract required the athlete to participate in play-off games for which he was eligible and to report to training camp or be subject to fines deductible from his basic salary. 690 F.2d at 46. The Internal Revenue Service adopted the court's position in Rev. Rul. 87-38, 1987-20 I.R.B. 7 (revoking Rev. Rul. 76-66, 1976-1 C.B. 189, which limited the contract term to the regular season).

27. 690 F.2d at 46.

28. *Id.*

29. *See* Rev. Rul. 55-727, 1955-2 C.B. 25; Rev. Rul. 74-108, 1974-1 C.B. 248; *see also* Allen v. Comm'r, 50 T.C. 466 (1968), *aff'd*, 410 F.2d 398 (3d Cir. 1969); Korfund v. Comm'r, 1 T.C. 1180 (1943).

nonresident athlete or entertainer must be allocated in some reasonable manner between United States and foreign source income if rights are waived both within and outside the United States. To avoid possible adverse tax consequence, a nonresident performer should enumerate expressly in the covenant the rights relinquished and attempt to allocate the value of those rights between source income in a reasonable and explainable fashion.

Sign-on bonuses in sports contracts are a type of negative covenant in which the player agrees not to perform for any club other than the contracting club. If, however, such a provision is coupled with a promise to perform for the contracting club, then the negative covenant becomes part of the overall contract to perform personal services in the United States, making both the bonus payment and the specified salary allocable to United States source income.[30] In *Linseman v. Commissioner*,[31] the tax court concluded that the sign-on bonus served the dual purpose of inducing the player to sign with the club and precluding him from playing for another club,[32] and thus allocated the bonus according to the number of games the team was to play within and outside the United States during the first of a six-season contract.[33] The negative covenant agreement in *Linseman* acknowledged the simultaneous execution of a contract to play and that both instruments were executed on the same day.[34] The facts and result of *Linseman* suggest that if a nonresident athlete promises not to perform for clubs outside the United States in exchange for a bonus payment in an effort to shift United States source income to a foreign source, such an agreement must be able to stand alone and not be connected to any affirmative obligation owed in the United States.[35]

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30. *See, e.g.*, Linseman v. Comm'r, 82 T.C. 514, 521-22 (1984).

31. 82 T.C. 514 (1984).

32. *Id.* The player argued that part of the bonus should be allocated to foreign source income because it was paid to him to secure a release from a contract with a Canadian club, and the performance of that contract would have occurred entirely outside the United States. *Id.* at 518-19. The court responded that, "It seems to us that irrespective of any theoretical considerations as to the nature of a sign-on bonus, the primary purpose for such a bonus is to induce the player to sign a contract to play with the bonus-paying club." *Id.* at 521.

33. Because alternate arguments were not before the court, it did not consider any other basis for allocation, such as the number of games played within and outside the United States over all six seasons covered by the contract nor the effect of the training periods or post season games on the allocation in light of the *Stemkowski* decision. *Id.* at n.20.

34. *See id.*

35. *See id.* Even if the negative covenant is formulated carefully, the desired result may not be obtained. In dicta the *Linseman* court suggested that the same result might be reached in different circumstances as well:

Lastly, sometimes it is difficult to ascertain whether compensation should be characterized as royalty of personal services income and therefore allocated accordingly. If an entertainer, or in the appropriate circumstances, an athlete, owns the intangible property right which generates money from its sale, such income is classified properly as royalty.[36] On the other hand, if the performer does not own a property interest in that right, income received from its sale is considered to be payment for personal services, even though it may be paid based upon some fractional percentage of sales.[37] Royalties derived from sales in the United States are considered United States source income whereas royalties generated from sales outside the United States should be considered foreign source income.[38] Compensation received for personal services is allocated according to the country where such services are performed.[39] In *Boulez v. Commissioner*[40] the tax court held that payment made to a nonresident orchestra leader based upon a percentage of the revenue generated by record sales constituted personal services income since CBS Records, not the maestro, owned the property right to the recording.[41] Furthermore, since the recording was made in New York, the money the conductor received was taxable as United States source income even though some of the sales revenue from which he received a share was generated abroad.[42] Thus, the classification of compensation paid to nonresident performers from the sale of intangible property rights as being either royalty or personal services income can reap significant tax consequences, even though payment may be realized as a percentage of sales under both classifications.

> In pointing to this fact, however, we are not suggesting that we would necessarily reach a different conclusion had the sign-on agreement not contained the above language or been limited to a promise not to play hockey for anyone else. Whatever the specifics of the sign-on agreement, the fact remains that the underlying purpose of such an agreement is to induce the player to perform the affirmative act of playing. It is that act which puts flesh on the bones of the sign-on agreement.

Id. at 522.

36. I.R.C. § 865(d)(1)(B) (West 1988).

37. Boulez v. Comm'r, 83 T.C. 584, 596 (1984).

38. *See* I.R.C. §§ 861(a)(4), 862(a)(4) (West 1987). Foreign source royalty income, however, may be treated as effectively connected income for tax purposes if it is realized in the ordinary course of trade through an office or fixed place of business in the United States. *Id.*

39. Treas. Reg. § 1.861-4(b)(1)(i) (as amended in 1975).

40. 83 T.C. 584 (1984).

41. *Id.* at 592.

42. *Id.* at 587-88. Although the case involved the provisions of a treaty between the United States and Germany, the basic principles enunciated are applicable to the circumstances discussed.

Nonresident performers may be able to plan in some circumstances to minimize United States tax liability. For example, nonresident performers who do not own a property interest in a given project might benefit from performing outside the United States since even income produced from United States sales and paid percentage-based to the performer would constitute foreign source income. In another situation, nonresident performers who wish to perform in the United States might benefit from obtaining ownership rights to the project and receiving payment in royalties, particularly if United States sales are not expected to be substantial. In summary, defining nonresident alien income as being either United States or foreign source income might be complicated in certain circumstances, but the distinction carries significant tax ramifications, some of which can be tailored in advance.

IV. NONRESIDENT INCOME TAX RATES AND ALLOWABLE DEDUCTIONS

If a nonresident alien's income is deemed to be United States source income, it may be taxed in one of two ways. That income which is effectively connected with a United States trade or business is taxed, after allowable deductions, at the graduated rates applicable to United States citizens and resident aliens.[43] Income from United States sources which is not effectively connected with a trade or business in the United States is taxed without an allowance for deductions at a flat rate of thirty percent,[44] unless that rate is reduced by a tax treaty.

If, however, the nonresident alien is not engaged in a trade or business in the United States at any time during the tax year, then no income received can be treated as effectively connected, even though it would have been treated as such if it had been received during a year in which the individual had been engaged in a trade or business in this country.[45] Thus, if a nonresident athlete or entertainer defers compensation which otherwise would be effectively connected income to a subsequent tax year when the athlete or entertainer is no longer engaged in a trade or business in the United States, that United States source income will be taxed at the flat rate of thirty percent instead of at the graduated rate.[46] If a deferred compensation plan is chosen to reduce

43. I.R.C. § 871(b)(1) (West 1987).

44. *Id.* § 871(a).

45. I.R.C. § 871(b)(1), (2) (West 1988).

46. *See supra* notes 43-45 and accompanying text. In deciding whether or not to defer compensation, the taxpayer should compare the amount of taxes which would be owed after deductions at the graduated rates with the amount which would be owed without deductions at the flat rate. Potential additional income generated from the investment of nondeferred compensation also should be compared to any savings likely to

tax liability, care must be taken to insure that there is no prior constructive receipt of payments and that the athlete or entertainer does not engage in any activity in the United States which might be considered a trade or business in the years for which the deferred payments are received.

For the most part, performing personal services in the United States is considered engaging in a trade or business. Therefore, compensation paid as wages is effectively connected United States source income.[47] Thus, a nonresident athlete or entertainer's salary, fees or prizes received for performing in the United States is effectively connected income, taxable at the graduated rates.[48] Conversely, compensation paid under negative covenants which are independent of any obligation to perform services in the United States may be taxed as fixed and determinable periodic payments at the flat rate of thirty percent.[49]

Generally, resident aliens may claim deductions according to the same rules applicable to United States citizens.[50] Conversely, nonresident aliens may claim some deductions only on income which is effectively connected to a trade or business in the United States; that is, the income which is taxed at the progressive rates.[51] Several deductions which can reduce the amount of taxable income are discussed below.

Ordinary and necessary travel expenses incurred while performing personal services in the United States, such as the costs of transportation, meals and lodging, may be deducted if such expenses are incident to travel,[52] reasonable,[53] incurred away from the foreign performer's

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be realized under a deferral plan.

47. I.R.C. § 864(b)(1) (West 1987). Most nonresident athletes or entertainers will be engaged in a United States trade or business. Examples of nonresident aliens not engaged in a trade or business include those trading in stocks, securities or commodities through a United States broker or for their own account. I.R.C. § 864(b)(2) (West 1987).

48. I.R.C. § 871(b)(1), (2) (West 1987).

49. Rev. Rul. 74-108, 1974-1 C.B. 248.

50. I.R.C. § 873 (West 1987).

51. I.R.C. § 871 (West 1987). Deductions for charitable contributions and casualty or theft losses can be claimed so long as the nonresident received income which is effectively connected to a United States trade or business, notwithstanding that those deductions are not connected to such income. I.R.C. § 873(b) (West 1987). Nonresident aliens may deduct contributions to IRA's or Keogh plans, so long as the retirement plan is related to compensation derived from a United States trade or business. I.R.C. § 219 (West 1988). State and local income taxes can be deducted according to the same rules applicable to United States citizens and resident aliens as long as the income so taxed is connected with a United States trade or business. State and local gasoline and personal property taxes not connected as such are not deductible. *See* Hanna v. Comm'r, 763 F.2d 171, 173 (4th Cir. 1985); I.R.C. § 873(b)(1), (2) (West 1987). Any deduction is allowable, however, only if the taxpayer files a Form 1040NR with the IRS. I.R.C. § 874(a).

52. Treas. Reg. § 1.162-2 (1960).

"tax home,"[54] and substantiated by adequate records.[55] In order for the nonresident to establish the required foreign tax home, the employment in the United States must be temporary[56] and generally defined as being limited to less than a year;[57] although in some circumstances a longer period of employment will not preclude the individual from claiming deductions for travel expenses.[58] To be deductible such expenses must be ordinary and necessary to a United States trade or business and not incurred as the result of personal choice in residence.[59] Nonresident athletes and entertainers in some circumstances may deduct moving expenses when changing their principal place of business to the United States.[60] Claiming such a deduction, however, precludes

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53. *Id.*

54. I.R.C. § 911(d)(3) (West 1988).

55. Treas. Reg. § 1.162-17(d) (as amended in 1962).

56. Treas. Reg. § 1.911-2(b) (1985).

57. Even if the assignment lasts less than a year, all the facts and circumstances will determine whether or not the assignment is temporary. Treas. Reg. § 1.911-2(d) (1985).

58. Employment expected to last for more than two years is not considered temporary. *Id.* Likewise, an assignment which is expected to last and does last for one year or more is not presumed to be temporary. This presumption, however, can be rebutted if the nonresident performer intends to return to the foreign tax home and establishes certain facts which suggest that the assignment in the United States is temporary. In such cases the foreign abode can be used as a tax home if: 1) a portion of the professional activity occurs in the vicinity of the claimed home and that home is used for lodging when performing there prior to and during the United States assignment; 2) living expenses at the claimed home are duplicated because business activities require travel; and 3) the claimed home traditionally and frequently is used for lodging by the taxpayer and immediate family members. Not all the facts must be established as each case depends on its facts and circumstances. *See* Rev. Rul. 83-82, 1983-1 C.B. 45-46; *see also* Rev. Rul. 60-189, 1960-1 C.B. 60; Rev. Rul. 74-453, 1974-2 C.B. 20-21; Comm'r v. Flowers, 326 U.S. 465 (1946).

59. For example, in Stemkowski v. Commissioner, 690 F.2d 40 (2d Cir. 1982), the court held that a hockey player's living expenses were non-deductible under I.R.C. § 162, since the expenses were not a business necessity, but rather were incurred as a result of the player's personal choice to reside in Canada. *Accord* Hanna v. Comm'r, 763 F.2d 171 (4th Cir. 1985) (disallowing hockey player's living expenses because he maintained a foreign residence).

Although neither *Stemkowski* nor *Hanna* attempted to deduct living expenses incurred at the foreign residence, such a claim could not be maintained because the expense would not be ordinary or necessary to earning income effectively connected to a United States trade or business.

60. I.R.C. § 217(c) (West 1987). Moving expenses can be deducted if the nonresident was a full-time employee for at least 39 weeks in the year immediately following the move. For self-employed nonresidents, such expenses can be deducted if the alien worked full-time for at least 39 weeks during the first year after the move and 78 weeks during the first two years after the move. In both cases the new job location must be at least 35 miles from the former job location, or alternatively, if there was no former job location, 35 miles from the former home. *Id.* Moving expenses incurred in returning to a foreign home are not deductible. Treas. Reg. § 1.911-3(e)(5) (1987).

the deduction of travel expenses for the same period.[61]

Business expenses represent another significant deduction allowed nonresidents on their effectively connected United States income and are commensurate with the deductions allowed United States citizens and resident aliens.[62] For athletes and entertainers "ordinary and necessary" business expenses can include fees paid to agents, coaches, trainers and legal consultants, professional association dues, and the cost of necessary uniforms, costumes or equipment.[63] Additionally, monies spent for education designed to maintain or improve required skills, such as fees paid for acting or singing lessons, are deductible.[64] If a nonresident athlete or entertainer is required to maintain a certain degree of physical fitness as a condition of employment, then the expenses incurred in achieving that condition are deductible business expenses as well.[65] The nonresident performer may deduct such educational or conditioning expenses, even if they are incurred outside the United States, provided they are effectively connected to the conduct of a trade or business within the United States.[66] The nonresident performer in such a case, however, must be able to allocate such expenditures between United States and foreign source income and be able to substantiate both the expenses and the allocations.[67] In sum, nonresi-

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61. Treas. Reg. § 1.161-1 (1960).

62. For business deductions allowed to United States citizens and residents, see I.R.C. § 162(a) (West 1987).

63. *See id.* For example, for nonresident entertainers, the cost of costumes, wigs and formal clothing, along with the associated laundering and dry cleaning expenses are deductible, so long as such attire is worn solely for professional performances. *See, e.g.*, Hutchison v. Comm'r, 13 B.T.A. 1188 (1928); Madge H. Evans, T.C.M.(P-H) ¶ 75,017 (1975); *see also* Stemkowski v. Comm'r, 690 F.2d at 40 (cost of answering fan mail and subscription to professional trade journal, "Hockey News," held to be ordinary and necessary business deduction); Linseman v. Comm'r, 82 T.C. 514 (1984) (fines levied by the league or club against professional athlete deductible).

64. I.R.C. § 873(a) (West 1987). The taxpayer must show a direct and proximate relationship between educational expenses and employment. *See* W.B. Crashley, T.C.M.(P-H) ¶ 79,513 (1980) (hockey player's deduction for cost of personal leadership course which benefited his mental attitude disallowed because of insufficient nexus between course and the athletic skills required for his employment).

65. *See, e.g.*, Hutchison v. Comm'r, 13 B.T.A. 1187 (1928) (physical training expenses of stunt man); Denny v. Comm'r, 33 B.T.A. 738 (1935) (physical training of actor preparing for a role as a prize fighter). For nonresident athletes, athletic club dues as well as conditioning expenses can be deducted so long as the physical activity associated with such costs is work-related and not recreational. *See* Stemkowski v. Comm'r, 82 T.C. 854 (1982) (hockey player's bowling and golfing expenses recreational in nature and nondeductible).

66. I.R.C. § 873(a) (West 1987).

67. 82 T.C. at 854, 867-68, *enforcing* 690 F.2d 40 (2d Cir. 1982). All business deduc-

dent performers may be able to reduce their income taxed at the marginal rates by claiming deductions, if such expenses are also effectively connected to a United States trade or business.

V. THE WITHHOLDING TAX AND OTHER ISSUES

Employers are required to deduct or withhold income tax from wages according to the amount of the salary earned and the number of withholding exemptions claimed.[68] Resident aliens and United States citizens are subject to the same graduated withholding requirements.[69] Additionally, any payments made to a nonresident alien for personal services rendered in the United States are subject to those graduated rates if an employment relationship exists.[70] On the other hand, if the nonresident is not an employee but an independent contractor, any payments made are subject to a flat thirty percent withholding rate.[71] Thus, nonresident athletes employed by franchises generally will be subject to the graduated rates while nonresident athletes or entertainers who perform independently on tours or at separate events will be subject to the flat rate.[72] In some circumstances, the final payment of compensation for independent personal services may be exempt either entirely or partially from withholding.[73] Withholding at the appropriate rate is, however, required for payments from gate receipts made to

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tions must be adequately substantiated, even those which are not complicated by allocation problems. I.R.C. § 274(d) (West 1987). In the absence of sufficient documentation, otherwise allowable deductions will be disallowed. *See* G.E. Bailey, T.C.M.(P-H) ¶ 84,610 (1984) (deductions for expenses associated with off-season conditioning activities denied for lack of satisfactory proof).

68. I.R.C. § 3402(a) (West 1988). In addition to allowable deductions, most nonresident athletes may claim one personal exemption of $1,000. I.R.C. § 151(b) (West 1988). Nonresidents from Mexico and Canada along with United States nationals are allowed exemptions for spouses and dependents as well if they meet the same requirements as those established for United States citizens. I.R.C. § 873(b)(2)(iii) (West 1987). Japanese nonresidents may claim extra exemptions in accordance with the provisions of a tax treaty between the United States and Japan. Tax Conventions, Mar. 8, 1971, United States-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365.

69. *See* I.R.C. § 3402(a)(1) (West 1988) for the graduated witholding requirement for United States citizens and resident aliens; I.R.C. § 871(b)(1) (West 1988) for nonresident aliens.

70. For the definition of an employee, see I.R.C. § 3121(d) (West 1987).

71. I.R.C. § 1441 (West 1987).

72. Even at the flat rate the nonresident must file a Form 1040NR with the IRS at the end of the tax year to report income effectively connected with a United States trade or business. The withheld amount is applied as an advance against liability computed on the form. Rev. Rul. 73-107, 1973-1 C.B. 376; Rev. Rul. 70-543, 1970-2 C.B. 172.

73. Treas. Reg. § 1.441-4(a)(1) (as amended in 1985).

nonresident performers at entertainment or sporting events.[74]

The payor of any such payments is known as the withholding agent and is required to withhold the appropriate amount at the source of the income.[75] A failure to withhold may cause the withholding agent to be liable for the tax that should have been paid in the event of a default.[76] The payor does not need to withhold if the payee has received a favorable Private Letter Ruling from the IRS which specifies that no withholding is required, or if both parties have reached an agreement with the Director of the Foreign Operations District who exempts the compensation for personal services from withholding requirements.[77] Additionally, no withholding is required of fixed or determinable income, other than compensation for personal services, which is effectively connected to a United States trade or business or of payments made to foreign corporations engaged in a United States trade or business, as long as Form 4224, "Exemption from Withholding of Tax on Income Effectively Connected with the Conduct of a Trade or Business in the United States," is filed with the payor.[78]

Nonresident athletes and entertainers need to be familiar with federal income tax laws and the intricacies of the withholding system.[79] They must also be familiar with state laws. In addition to federal laws governing the taxation of income, many states impose income taxes at variable rates on individuals or corporations which earn income within their borders.[80] Furthermore, some cities, such as New York, impose municipal income taxes.[81] Nonresident performers should become aware of the requirements of these tax systems as well. Gift and estate taxes pose additional concerns for some nonresident performers.[82] Per-

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74. *Id.*

75. *See* I.R.C. § 1442, 3402(a) (West 1987).

76. I.R.C. § 1461 (West 1976). The ultimate liability of the payor may be compounded, thus making the payor's payment to the IRS additional compensation upon which tax must be withheld and paid.

77. Fraade, Gardner & Stewart, *supra* note 3, at 207-08. As an accommodation to the entertainment industry, the IRS has developed the Central Withholding Agreement to simplify the withholding process for tours which embrace numerous cities and payors. *See* IRS Manual V(13) 52-4, ¶ 1 (Dec. 3, 1982). This agreement between the IRS, nonresident performer and the withholding agent specifies a set amount to be withheld, and in cases where the performer will incur substantial expenses, may reduce any amount withheld from the flat rate of thirty percent to one closer to the ultimate tax liability. *Id.*

78. IRS Manual V(13) 52-4, ¶ 8 (Dec. 3, 1982).

79. For a further discussion concerning withholding requirements, see Fraade, Gardner & Stewart, *supra* note 3, at 217-18; Lipton & Fuller, *supra* note 5, at 449-51; Histrop, *supra* note 14, at 1068-69.

80. *See generally* Zagaris, *supra* note 17.

81. *Id.*

82. A complete discussion of issues surrounding these taxes is beyond the scope of

haps the most important inquiry for nonresidents is the effect of tax treaties on all tax law. The provisions of tax treaties supersede otherwise existing laws and may reduce tax liability. Some treaties, however, contain specific provisions which adversely affect a highly remunerated international athlete or entertainer's ability to avoid taxation.

VI. TAX TREATIES: INTRODUCTION AND OVERVIEW

Tax treaties[83] exist primarily for two reasons. First, they attempt to prevent the double taxation of income. Without treaties, overlapping taxing powers could force the taxpayer to be subject to taxation by more than one taxing authority. Second, treaties help to prevent the evasion of tax responsibility. Additionally, treaties often include a single article which provides for the exchange of information between the treaty countries[84] and thus, enhances the ability of the world's governments to keep abreast of the business activities of their citizens.

Where a tax treaty exists between the United States and a foreign government, the treaty provisions, rather than the Internal Revenue Code, govern the extent to which each government may tax its residents.[85] The Internal Revenue Code provides that income of any kind, to the extent required by a treaty obligation of the United States, is not to be included in gross income and is to be exempted from taxation.[86] Thus, through the use of treaty articles, the nonresident alien entertainer or athlete may benefit by being able to exempt all or a part of United States source income[87] which otherwise would be considered

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this paper. *See generally* Wildes & Grunblatt, *Domicile for Immigration and Federal Gift and Estate Tax Purposes—Is a Harmonious Rule Possible?*, 38 IMMIGRATION AND NATIONALITY LAW SYMPOSIUM 821 (1984); Zagaris, *supra* note 17, at 586-601.

83. The tax treaty finds its roots in an agreement signed between Austria-Hungary and Prussia in 1899. Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 4, 10 n.25 (1986). Its purpose was to provide relief from double taxation of income and property. *Id.* The signing of similar treaties grew in popularity among European countries, but the outbreak of World War I left them worthless and unenforceable. Later efforts toward establishing a cooperative framework for a new set of treaties, enacted after the war, produced three model treaties. *See id.* at 10-11.

The majority of the world's treaties were created after World War II, with many of those treaties following the models created by the Organization of European Economic Cooperation and its successor, the Organization of Economic Cooperation and Development ("O.E.C.D."). Today, many of the existing treaties in force use the 1963 draft or 1977 final version of the Model Double Taxation Convention on Income and on Capital. *See id.* at 11-13 as a framework for treaty negotiation.

84. *See id.* at 68.

85. U.S. CONST. art. VI; I.R.C. § 7852(d) (West 1987).

86. I.R.C. § 894(a) (West 1987).

87. Source rules help to define which countries have a right to tax certain portions of the nonresident alien's income. Treaties attempt to eliminate the double taxation of in-

taxable in the United States.

Prior to 1970, the United States maintained a favorable entertainer and athlete point of view with respect to the treatment of an entertainer's or athlete's income. The United States-Canada income tax treaty, which was signed on January 1, 1941, was representative of the United States' favorable entertainer and athlete attitude.[88] In negotiating the treaty, the United States sought the inclusion of a paragraph that negated the text contained within an earlier article which clearly provided that any exemption privileges were not to apply to "actors, artists, musicians and professional athletes."[89] That position changed, however, in 1970 as the government saw that the United States earnings of nonresident alien entertainers and athletes were too great to allow the income to leave the country without taxation.

Since 1970, the United States has reversed its favorable entertainer and athlete position and has entered into treaties which contain unfavorable entertainer and athlete provisions. The United States-Trinidad and Tobago treaty signed on January 1, 1970 reflects the United States' change in attitude towards entertainer and athlete compensations as new provisions regarding income exemptions were included.[90] Previously, the nonresident alien entertainer or athlete was able to find relief in the form of exemptions under either the independent or dependent personal services articles.[91] Independent personal

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come by limiting the treaty country's right to tax only the income which arises from the performance of services within that country. Rules for the determination of source of income and royalties, as well as other forms of compensation, generally are found within each particular treaty.

88. Convention for Double Taxation: Taxes on Income, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983.

89. Convention of June 12, 1950 to supplement and modify the Convention of Mar. 4, 1942, 2 U.S.T. 2235, 2243, T.I.A.S. No. 3916.

90. Convention on Double Taxation, Jan. 9, 1970, United States-Trinidad-Tobago, art. 17, 22 U.S.T. 164, T.I.A.S. No. 7047.

91. Personal services articles generally intend to define the performance of personal services as either dependent or independent. They also determine which country has either a prior or exclusive right to tax income. In most cases, the country of the taxpayer's residence is given an exclusive right of taxation, unless the taxpayer exceeds certain prescribed thresholds. The threshold tests may include any combination of the following: 1) time limit tests, which provide a maximum number of days that a nonresident alien entertainer or athlete may spend in a foreign country and earn compensation without being taxed; 2) fixed base tests, which allow some relief from taxation if the taxpayer does not operate with a fixed base in the source country; and 3) money limit tests, which prescribe the maximum amount of compensation that can be earned in a source country without taxation by the source country. Depending on whether the services are designated as being dependent or independent, the nonresident alien entertainer or athlete may be subject to different threshold tests. *See* Treaty on Double Taxation, Mar. 4, 1942, United States-Canada, arts. XIV, XV, 56 Stat. 1399, T.S. No. 983; Rev.

services generally are defined as "services performed by an individual for his own account where he receives the income and bears the losses arising from such services;"[92] and dependent personal services generally are defined as "salaries, wages and other similar remuneration derived . . . in respect of an employment . . . . "[93] The signing of the treaty initiated new restrictions as specific provisions concerning the treatment of income earned by a "public entertainer, theater, motion picture or television artist, musician, or athlete"[94] were included within a personal services article for the first time. Under the newer treaties, athletes and entertainers only may be entitled to favorable tax treatment if the services performed are dependent, and even this classification is subject to restrictions.[95]

Three subsequent treaties which the United States entered into between the years 1970 and 1975 with Belgium,[96] Iceland,[97] and Japan[98] contain separate articles which allow income earned within the

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Rul. 54-119, 1954-1 C.B. 156; Treaty on Double Taxation: Taxes on Income and Capital, May 7, 1975, United States-Iceland, arts. XVIII, XIX, 26 U.S.T. 2004, T.I.A.S. No. 8151.

92. Convention on Double Taxation: Taxes on Income and Capital Gains, Dec. 31, 1975, United States-United Kingdom, art. 14, 31 U.S.T. 5668, 5682, T.I.A.S. No. 9682, at 15. A clear and concise definition of independent personal services is difficult to ascertain. Most of the newer United States treaties, such as the ones with Hungary and Belgium, define independent personal services as "personal services in an independent capacity." *See* Convention on Double Taxation: Taxes on Income, Feb. 12, 1979, United States-Hungary, art. 18, 30 U.S.T. 6357, 6379, T.I.A.S. No. 9560 at 23; Convention on Double Taxation: Taxes on Income, July 9, 1970, United States-Belgium, art. 14, 23 U.S.T. 2687, 2701, T.I.A.S. No. 7463, at 15. The O.E.C.D. model defines independent personal services as "professional services or other activities of an independent character." *See* Model Double Taxation Convention on Income and Capital, Apr. 1, 1977, O.E.C.D. art. 14, para. 2, *reprinted in* 4 DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS 481 (1978) [hereinafter O.E.C.D. Convention].

93. O.E.C.D. Convention, *supra* note 92, art. 15. Significant to all dependent personal services articles is the existence of an employment relationship. No formal definition of what constitutes an employment relationship can be found in either of the model treaties. The reader is advised to refer to the existing laws of the country in which the services are performed for the applicable definition. For factors considered when determining a United States employment relationship, see Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 75-41, 1975-1 C.B. 323. For the significance of the dependent personal services article as it applies to the nonresident alien entertainer, see *infra* notes 127-53 and accompanying text.

94. Convention on Double Taxation, Jan. 9, 1970, United States-Trinidad-Tobago, art. 17, 22 U.S.T. 164, T.I.A.S. No. 7047.

95. Convention on Double Taxation, Dec. 31, 1975, United States-United Kingdom, *supra* note 92, art. 15.

96. United States-Belgium, *infra* note 99, art. 14.

97. United States-Iceland, *infra* note 99, art. 18.

98. United States-Japan, *infra* note 99, art. 17.

United States from the performance of independent personal services to be exempt from United States taxation. They also, however, provide that the exemption is not to be available to a "public entertainer such as a theater, motion picture, or television artist, a musician, or an athlete."[99] This bias is directed only at those entertainers or athletes who perform their services as independent contractors. An exemption sometimes is available, however, if the income qualifies, under the dependent personal services article of the same treaty, as dependent personal services income from employment by a corporation which is a resident of the foreign country.[100]

The unlimited exemptions provided within the dependent personal services articles of older treaties are changing as the United States enters into newer treaties. As evidenced by the United States-United Kingdom treaty of 1980, exemptions of United States earnings from taxation are no longer unlimited, but rather subject to an exemption limit of $15,000.[101] The exemption limit includes expenses borne on an individual's behalf by others and applies to entertainers or athletes regardless of whether the services are dependent or independent.[102]

The apparent movement to strip the nonresident alien entertainer or athlete of many previous benefits can be attributed, in part, to the Model Treaties which were drafted by the Organization for Economic Cooperation and Development ("O.E.C.D.") and described in reports issued by the organization in 1963 and 1977.[103] Articles 14 and 15 of the O.E.C.D. Model detail the conditions under which income derived from the performance of services outside the country of residence[104]

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99. Convention on Double Taxation, July 9, 1970, United States-Belgium, art. 14, para. 2, 23 U.S.T. 2687, T.I.A.S. No. 7463; *see also* Convention on Double Taxation, Mar. 8, 1971, United States-Japan, art. 17, para. 2, 23 U.S.T. 967, T.I.A.S. No. 7365; Convention on Double Taxation, May 7, 1975, United States-Iceland, art. 18, para. 2, 26 U.S.T. 2004, T.I.A.S. No. 8151.

100. *See* Convention on Double Taxation, July 9, 1970, United States-Belgium, art. 15, 23 U.S.T. 2687, T.I.A.S. No. 7463.

101. Convention on Double Taxation, Dec. 31, 1987, United States-United Kingdom-Northern Ireland, art. 17, 31 U.S.T. 5668, T.I.A.S. No. 9682.

102. *Id.*

103. *See* O.E.C.D. Report of The Fiscal Committee: Draft Double Taxation Convention on Income and Capital 167 (1963); *see also* O.E.C.D. Model Double Taxation Convention on Income and Capital 1977, 1 Tax Treaties (CCH) ¶ 151 (1980) [hereinafter O.E.C.D. Model].

104. Residence is determined by provisions, contained within many treaties, which are designed to prevent the alien from being treated as a resident of both treaty countries. If an individual is considered a resident of two countries, a final determination of country residence must be made through a predetermined set of residence "tie-breakers." Both the United States and O.E.C.D. models provide that if the individual has a

may be exempt from taxation by the source country.[105] These provisions are negated for the entertainer or athlete in Article 17.[106] Article 17 expressly states that those provisions in Articles 14 and 15 are not available to public entertainers such as motion picture, radio, television artists, musicians, and athletes.[107] In addition, the 1977 draft adds an additional paragraph to Article 17.[108] The new paragraph states that income paid to a third party for the performance of services by an individual is subject to taxation.[109]

VII. TAX PLANNING FOR THE NONRESIDENT ENTERTAINER OR ATHLETE

A successful plan for the minimization of an entertainer or an athlete's global tax bill must carefully consider not only the tax laws of the country in which the services are performed, but also the way in which those tax laws combine with applicable tax treaties, the nationality of the entertainer or athlete, and the country of residence. The countries of nationality, residence, and performance all contain different regulations and provisions for taxation and can act as a double-edged sword. If not coordinated properly, the entertainer or athlete could pay an enormous effective tax rate on global income. On the other hand, proper planning can prove quite beneficial in lowering the overall tax bill and effective tax rate.

Although faced with the efforts to limit tax avoidance by nonresident entertainers and athletes by the world's taxing authorities' aim,

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permanent home in one of the treaty countries then that country will be considered the country of residence. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 49 n.151 (1982). If a permanent home exists in both countries, or in neither of the treaty countries, then another set of tests is applied. These tests attempt to determine residency through the examination of the individual's vital center of interests, habitual place of abode, and nationality. If no determination is made, the government authorities will make a mutually acceptable determination. For example, the United States-Belgium treaty provides for evidence first to be determined by where the person maintains a permanent home, second by where the person's economic and personal interests lie, third by where the person's habitual abode is located, fourth by which country the person holds citizenship, and, finally, by mutual agreement of the governments of the contracting states. Convention for the Avoidance of Double Taxation, July 9, 1970, United States-Belgium, art. 4, para. 2, 23 U.S.T. 2687, 2692-93, T.I.A.S. No. 7463, at 7-8; *see also* Convention for the Avoidance of Double Taxation, Feb. 12, 1979, United States-Hungary, art. 4, para. 2, 30 U.S.T. 6357, 6364-65, T.I.A.S. No. 9560, at 8-9; Convention for the Avoidance of Double Taxation, Mar. 8, 1971, United States-Japan, art. 3, para. 3, 23 U.S.T. 967, 972-73, T.I.A.S. No. 7365, at 6-7.

105. O.E.C.D. Model, *supra* note 103, arts. 14 & 15.

106. *Id.* art. 17.

107. *Id.*

108. *See* Fraade, Gardner & Stewart, *supra* note 3, at 220.

109. *See* Weiss, *supra* note 14, at 123.

the nonresident alien may be able to find tax relief through the use of certain treaty articles.

The "business profits" provision, sometimes referred to as the "industrial or commercial profits" provision contained within many tax treaties, may allow the nonresident alien entertainer or athlete to exclude from the calculation of taxable income all "business profits" earned from a business enterprise.[110] The opportunity to exempt business profits has important implications for the nonresident alien entertainer or athlete who wishes to use the foreign corporation as a vehicle for sheltering income from taxation.[111]

To determine if the foreign taxpayer has incurred any United States tax liability, a test of whether or not the nonresident alien entertainer or athlete has a permanent establishment in the United States must be applied.[112] If the foreign taxpayer has a permanent es-

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110. Treaties differ on the inclusion of certain items of income in the definition of business profits, and it is advisable to refer to the treaty in question to find the specific items of income included in the definition. For example, the United States-Germany treaty defines "industrial or commercial profits" as "income derived by an enterprise from the active conduct of a trade or business, including income derived by an enterprise from the furnishing of services of the employees or other personnel . . . ." Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Federal Republic of Germany, art. 3, para. 5, 5 U.S.T. 2768, T.I.A.S. No. 3133. Excluded from the definition are dividends, interest, royalties, income from real property and natural resources, capital gains, and labor and personal services. *See id.* The United States-United Kingdom treaty provides:

> Business profits [include] income derived from manufacturing mercantile, banking, insurance, agriculture, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of cinematographic films or tapes used for radio or television broadcasting or from copyrights thereof . . . [such] term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

Convention for the Avoidance of Double Taxation, Mar. 15, 1979, United States-United Kingdom-Northern Ireland, art. 7, para. 7, 31 U.S.T. 5668, T.I.A.S. No. 9682.

111. If a foreign "loan-out" corporation is to be utilized by the nonresident alien entertainer or athlete, the definition of "industrial or commercial profits" within some treaties may include compensation received for the performance of personal services and will exempt from United States taxes the income received from providing the services of the nonresident alien entertainer or athlete. *See* Rev. Rul. 67-321, 1967-2 C.B. 470. If the definition of "industrial or commercial profits" excludes the inclusions of income received for the performance of personal services, the Article's provisions may not provide any relief for the nonresident alien entertainer's or athlete's "loan-out" corporation. *See* Convention for the Avoidance of Double Taxation with respect to Taxes on Income, May 24, 1951, United States-Switzerland, art. II, para. 1, sub. para. h, 2 U.S.T. 1751, T.I.A.S. No. 2316; *see also supra* notes 82-100 and accompanying text.

112. Permanent establishment is defined by three tests: an asset test, an agency test, and an activity test. The asset test determines which kinds of assets, for example, a

tablishment within the United States and the income is effectively connected to that permanent establishment, then the foreign taxpayer's income, net of allowable deductions, is subject to tax.[113] If the income is not effectively connected, then the nonresident entertainer or athlete will be treated as not having a permanent establishment within the United States for purposes of applying any treaty provisions for exemptions from tax.[114]

It is important to note that while "business profits" provisions usually allow the nonresident alien entertainer to plan his business operations so as to avoid taxation in one country, taxes ultimately will have to be paid to a taxing authority. The treaty laws provide that a nonresident alien's business operations may avoid taxation in the source country, but invariably, taxes will have to be paid in the home country of business operations.[115] If the business operations of the nonresident alien entertainer or athlete business operations have a permanent establishment in two countries, the foreign operation will be required to pay taxes on only that portion of income which is effectively connected to the foreign country.[116] The home country of operations will be able to tax only those business profits effectively connected to the home country operations.[117] Therefore, it is advisable that both the marginal and effective rates of taxation for each country involved be analyzed when deciding on the placement of a permanent

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branch office, store, or factory maintained by the business operation within the treaty country, will constitute a permanent establishment. The agency test determines the extent to which the activities of the business establishment will constitute a permanent establishment, even if the business operation does not maintain a fixed place of operation within the country. The activity test determines the extent to which the enterprise may carry on certain activities, such as storing, displaying, delivering or purchasing goods in the other treaty country, without such activities constituting a permanent establishment. A fixed place of business generally constitutes a permanent establishment only if it is used to engage in a continuous course of commercial activity. There are two fundamental requirements. One is the active conduct of business; the other is the continuity of such activities. Under United States rules, an enterprise may be taxed if a permanent establishment exists at any time during the taxable year, even if it does not exist at the moment the particular income is earned. Jules Samann, 36 T.C. 1011 (1961), *aff'd*, 313 F.2d 461 (4th Cir. 1963), 11 A.F.T.R.2d (P-H) 664, 63-2 U.S. Tax Cas. (CCH) ¶ 9254; Georges Simenon, 44 T.C. 820 (1965).

113. I.R.C. § 894(b) (West 1987).

114. *Id.*

115. The requirement for the nonresident alien to be a resident for taxing purposes of one of the treaty countries prevents the nonresident alien entertainer or athlete to benefit from the provisions without having liability for tax in the country of residence. *See supra* note 104 for a discussion of residence determination.

116. *Cf.* I.R.C. § 882(a)(1) (West 1988).

117. *See* I.R.S. Priv. Ltr. Rul. 85-24-04 (Feb. 12, 1984); Rev. Rul. 84-17, 1984-1 C.B. 308.

establishment.

The "dividends paid rule" provision allows for the exemption from United States withholding tax on dividends paid by a foreign corporation to persons other than United States citizens, residents, or corporations.[118] If, however, the foreign corporation earns greater than fifty percent of the profits from which it pays dividends from permanent establishments located within the United States, a portion of the dividends will be taxed according to the actual percentage of income attributed to the permanent establishment or establishments.[119] Of the newer United States treaties, some follow the O.E.C.D. Model Treaty and provide for dividends to be treated as income from sources within a country if the dividends are paid by a corporation of that country.[120]

"Commercial traveler" provisions allow for income earned in the source country by a resident of another country to be exempt from taxation.[121] Such an exemption is usually limited to an individual who visits the host country for business or educational purposes, and is similar to the exemption provided in Section 861(a)(3) of the Internal Revenue Code.[122] Often, however, the exemption requires that the nonresident alien entertainer or athlete perform services under contract as an employee of a resident of the host country.[123]

Although the commercial traveler provisions are fairly common in United States treaties, anti-abuse efforts have initiated the inclusion of articles to exclude entertainers and athletes from the coverage provided by the personal services articles. As stated previously, Article 17 of the O.E.C.D. Model Convention provides that entertainers and ath-

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118. Certain exceptions to the foreign corporation's ability to exempt its dividends paid to shareholders from the withholding tax exist in some treaties. Those exceptions are contained within the treaties' articles and provide that the dividends will be taxable if paid to a United States citizen or if effectively connected with a United States permanent establishment or fixed base. These exceptions generally do not apply to the nonresident alien entertainer or athlete since any "loan-out" corporation usually will be established outside of the United States. *See* Convention for the Avoidance of Double Taxation, Feb. 12, 1979, United States-Hungary, art. 9, para. 5, 30 U.S.T. 6357, 6372, T.I.A.S. No. 9560, at 16-17; *see also*, Convention for the Avoidance of Double Taxation, July 9, 1970, United States-Belgium, art. 10, 23 U.S.T. 2687, 2697, T.I.A.S. No. 7463, at 12. For a further discussion of the "loan-out" corporation, see *infra* notes 125-61 and accompanying text.

119. This important exception was initiated by the United States Model Treaty. United States Model Income Tax Treaty, 1977, United States Treasury, art. X, *reprinted in* Tax Treaties I (P-H) ¶ 1019.

120. Commentary on Model Double Taxation Convention on Income and on Capital, 1977, O.E.C.D., art. X.

121. Weiss, *supra* note 14, at 115.

122. *See supra* note 16 and accompanying text.

123. Rev. Rul. 74-330, 1974-2 C.B. 278, 280.

letes may be taxed in the country which is the source of their income.[124] Given these measures, it becomes increasingly clearer that if the nonresident alien entertainer or athlete is going to obtain the benefits offered by a treaty, the use of a "loan-out" corporation will be necessary.

VIII. THE "LOAN-OUT" CORPORATION

With the use of a "loan-out" corporation, the nonresident alien may be able to receive wages under the provisions of the dependent personal services articles and dividend distributions under the "dividends paid" provisions.[125] The "loan-out" corporation may be able to exempt its earnings under the provisions contained within the "business profits" articles.[126] In its simplest form, the "loan-out" consists of two contractual relationships.[127] The first contract is entered into by the corporation and the entertainer or athlete.[128] The entertainer or athlete agrees to provide personal services to the corporation in exchange for a mutually acceptable salary which is usually subject to the customary withholding and employment taxes.[129] The second contract is between the company and the producers, teams, clubs, or agents.[130] This contract typically provides that the company agrees to supply the services of the nonresident alien entertainer or athlete at a predetermined rate or fee.[131] The contract establishes an independent contractor relationship between the company and the producers, teams, clubs, or agents.[132] This relationship will insure that all of the fees or compensation paid to the company will be free from any withholding or other employment taxes.[133] The double "loan-out" corporation includes two intermediaries between the entertainer or athlete and the receiver of services.[134] The presence of another foreign entity provides a potential for a greater variety of arrangements under which services of the entertainer or athlete services can be provided. Although more complex

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124. *See* O.E.C.D. Model, *supra* note 103, art. 17.

125. Short, *Tax Benefits of the Entertainer's Loan-out Corporation*, in COUNSELING CLIENTS IN THE ENTERTAINMENT INDUSTRY 1269, 1270-1300 (M. Silfen, ed., Practicing Law Inst. 1982).

126. *Id.* at 1301-06.

127. *Id.* at 1270.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* at 1316-17.

arrangements are possible under a double "loan-out" arrangement, the principles of law applied are no different than those present in the single "loan-out" arrangement.

"Loan-out" corporations frequently come under attack by the Internal Revenue Service. The IRS analyzes "loan-out" arrangements with the intent of determining if, in fact, the nonresident alien is performing services as an employee of a corporation in a dependent capacity. If a nonresident entertainer or athlete is a sole shareholder of such a corporation and negotiates, signs, and guarantees the contract which loans the services, then the IRS views the nonresident as a provider of independent services, not as an employee of the corporation.[135] Similarly, if the corporation is owned by a third party group of shareholders who earn a small dividend while all company profits are paid to the entertainer or athlete in the form of a salary or bonus, the nonresident will not be considered an employee.[136] If, however, the nonresident athlete or entertainer owns no stock in the corporation, assumes no financial risk, exercises no control over the "loan-out" arrangements, and performs under a fixed salary or exclusive agreement with the corporation which is unrelated to corporate profits, then the nonresident will be viewed as an employee of the corporation and hence, entitled to benefits under the tax treaty.[137]

When planning the construction of the "loan-out" corporation, the tax planner must consider the issues of residence, permanent establishments, employment relationships, and meaningful reasons for existence. An entertainer or athlete must be considered a resident of one of the treaty countries for taxing purposes in order to qualify for the exemptions afforded by a particular treaty.[138] Both the United States Treasury and O.E.C.D. Model Treaties define an individual as being eligible for tax treaty benefits if the individual is considered a resident for taxing purposes on worldwide, not just source income.[139] While this criterion may not be expressed in existing tax treaties, it could be considered a relevant issue by the IRS when determining tax liability in a particular case. A general principle for all treaties is that if the term is

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135. Rev. Rul. 74-330, 1974-2 C. B. 278; Rev. Rul. 74-331, 1974-2 C. B. 281-282.

136. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 331, 1974-2 C.B. 282.

137. The two IRS rulings which delineate the tax treatment afforded "loan-out" corporations were based on Article XI of the United States-United Kingdom tax treaty which was replaced by a new treaty ratified in 1980. Convention Regarding Double Taxation, Dec. 31, 1975 - Mar. 15, 1979, United States-United Kingdom, 31 U.S.T. 5668, T.I.A.S. No. 9582. Nonetheless, the principles enunciated in the rulings are applicable to the new treaty and can be applied to other current United States tax treaties.

138. Convention with Respect to Taxes on Income and Property, Dec. 3, 1971, United States-Norway, arts. III, XIII, XIV, 23 U.S.T. 2832, T.I.A.S. No. 7474.

139. I.R.C. § 894(a) (West 1982).

not defined within the text of the treaty, the term will be given meaning as is provided under the taxing laws of the country applying the provision.[140] In keeping with these principles of residence, the nonresident alien entertainer or athlete ultimately will have to display a real tax nexus to the country of residence. The submission of tax returns previously filed with the country of residence should provide sufficient evidence to the IRS that the entertainer or athlete has residence status for taxing purposes with the other contracting state.

In addition to the issue of residence for the nonresident alien entertainer or athlete, residence for taxing purposes also must be met when creating the "loan-out" corporation in a tax treaty country. If residence is established, the foreign corporation is considered the "foreign connection" for the entertainer or athlete seeking to qualify for an exemption from United States earnings.[141]

The avoidance of a permanent establishment in the United States is necessary for the exemption of fees paid by the corporation for furnishing the entertainer's or athlete's services.[142] A permanent establishment generally is considered to exist if the foreign corporation has an existing physical facility in the United States or if the business dealings within the United States are transacted without the use of an agent or representative who has the power to negotiate contracts on behalf of the foreign "loan-out" corporation.[143] The existence of a permanent establishment, however, will only preclude the foreign corporation from exempting its fees from United States taxation. The existence of a permanent establishment has no effect on the entertainer's or athlete's ability to earn compensation that is free from taxation.[144] If the fees earned by the corporation are nominal, then it may be advisable to create a permanent establishment within the country of

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140. Convention for the Avoidance of Double Taxation with respect to Taxes on Income, May 24, 1951, United States-Switzerland art. III, para. 2, 2 U.S.T. 1751, T.I.A.S. No. 2316; *see* Johansson v. United States, 336 F.2d. 809 (5th Cir. 1964), *aff'd per curiam*, 374 F.2d 809 (5th Cir. 1967). In *Johansson*, the court held that the United States was not bound by the determination of residency made by the Swiss Tax Authorities. The court determined that the applicable standards of residency were those contained in the internal revenue regulations which suggested that residency be measured by a substantial physical presence in a country. Thus, the actual number of days Mr. Johansson spent both inside and outside of Switzerland was considered in determining that he was not a resident of Switzerland.

141. *See* Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281. The foreign connection requirement applies only to those entertainers who are in an employment relationship and not to those entertainers who are independent contractors and self-employed.

142. *See supra* note 112 for the definition of a permanent establishment.

143. *See* Treas. Reg. § 1.864-7(b), (d) (1972).

144. Rev. Rul. 70-247, 1970-1 C.B. 156.

performance.

Regarding the employment relationship, two IRS rulings provide some insight for the proper structuring of a suitable "loan-out" arrangement.[145] The most important factor in establishing a valid "loan-out" arrangement is the existence of an employer/employee relationship.[146] In establishing an employment relationship, consideration is given to the nature of the services provided in order to determine whether the services are performed by the individual for his or her own account or for an employer.[147] The establishment of a proper employment relationship permits the entertainer or athlete to be readily identified as an employee of the "loan-out" corporation and prevents the finding of an employment relationship between the entertainer or athlete and the individual or corporation who contracts with the "loan-out" corporation for the entertainer's or athlete's services.[148] The corporate employment relationship also must be of significant substance and not of mere legal form.[149]

Control of the services performed must rest with the employer and not the employee.[150] The employee must be subject to the control of the employer not only in the service to be performed, but also in the manner in which the service is to be performed.[151] The control of the corporation over the entertainer or athlete will further substantiate the position that the entertainer or athlete indeed has an employment relationship with the foreign corporation.[152] Concurrently, the foreign "loan-out" corporation should be an independent entity of which the entertainer or athlete has no control. If the entertainer or athlete does exercise control, questions may then be raised over the validity of any employment relationship between the entertainer or athlete and the corporation.

Additionally, if a "loan-out" arrangement is to be considered valid, the corporation, not the entertainer or athlete, must bear the financial risks associated with the "loaning-out" of the entertainer's or athlete's services.[153] The earning of a fixed salary by the entertainer or athlete, regardless of whether or not the individual is "loaned-out" suggests

145. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281.

146. *See* Johansson v. United States, 336 F.2d 809 (5th Cir. 1964).

147. *See supra* notes 91-93.

148. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281.

149. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281; *see also* Treas. Reg. § 31.3401(c)-1(c) (as amended in 1970); Rev. Rul. 75-503, 1975-2 C.B. 352.

150. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281.

151. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281.

152. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281.

153. Rev. Rul. 68-248, 1968-1 C.B. 431; Rev. Rul. 75-503, 1975-2 C.B. 352.

that a valid employer/employee relationship exists with the corporation bearing the economic risks.[154] On the other hand, if the compensation of the entertainer or athlete is based upon the amount of revenue generated by the performance of services, the entertainer or athlete will bear the financial risk if the person who contracts for the services of the entertainer or athlete fails to pay.[155]

If the foreign corporation acts as a booking agent for the entertainer or athlete, an agency relationship between the entertainer or athlete and the corporation will be considered to exist, rather than an employment relationship.[156] Thus, the entertainer or athlete will not be able to benefit from the provisions of the dependent personal services articles. The absence of an employment relationship with the booking agent in all likelihood will connect the entertainer or athlete to the individual or corporation who contracts for the entertainer's or athlete's services, and require the income arising from the performance of those services to be treated as independent personal services income. If, however, the foreign "loan-out" corporation engages a number of entertainers or athletes in personal service contracts, the entertainers or athletes will be considered employees of the corporation, and any "loan-out" arrangement will be viewed as a temporary use of their dependent services.[157]

Finally, the successful "loan-out" corporation is one that has a meaningful reason for existence. The validity of its existence is determined not by the corporation's declared purpose, but rather by the manner in which it operates.[158] To avoid being considered as a "sham" operation, the corporation must perform some other function besides that of tax minimization.[159] Although corporations are afforded some tax advantages that are not extended to individuals, the corporation will be considered valid as long as there is the performance of business

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154. Rev. Rul. 68-342, 1968-1 C.B. 433.

155. *Id.*

156. *See* RESTATEMENT (SECOND) OF AGENCY § 1(1) (1957).

157. Rev. Rul. 74-330, 1974-2 C.B. 278.

158. *See* Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943). In *Moline*, the Supreme Court stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

Id. at 438.

159. Short, *supra* note 125, at 1312-13.

activity.[160] If the corporation is considered a "sham," gross income earned may be assigned to the individual athlete or entertainer.[161] Because such an allocation may result in the individual's income exceeding the salary paid by the corporation, tax liability could rise proportionately, and thus, the objective for which the entertainer or athlete established the "loan-out" corporation will not be achieved.

IX. CONCLUSION

Complex rules and regulations govern the foreign and United States tax treatment of income received by foreign entertainers and athletes. Tax planning for these individuals requires that careful attention be paid not only to tax laws of the United States, but also to the specific provisions of United States treaties with other nations. An awareness of the applicable laws governing the taxation of nonresident alien entertainers and athletes, however, can result in the minimization of tax liability.

160. *Id.*

161. Section 482 of the Internal Revenue Code provides:

> In any case of two or more . . . businesses . . . owned or controlled directly or indirectly by the same interests, the secretary may distribute, apportion or allocate gross income . . . between or among such . . . businesses if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such business.

I.R.C. § 482 (1987). It remains unclear as to whether the cases that have applied Section 482 to allocate income to a shareholder who purportedly acts as a corporate employee in the conduct of business affairs have made such allocations away from the corporation to the employee or whether the intention is to reverse a prior assignment of income from the employee to the corporation. If the intention is the latter, the "commercial traveler" exemption may not apply. *See* Rubin v. Comm'r, 56 T.C. 1155 (1971).